Committee on Resources,

Subcommittee on Energy & Mineral Resources

energy - - Rep. Barbara Cubin, Chairman
U.S. House of Representatives, Washington, D.C. 20515-6208 - - (202) 225-9297

Witness Statement

TESTIMONY OF M. BRIAN McMAHON
FOR THE CITY OF LONG BEACH AS TRUSTEE
FOR THE STATE OF CALIFORNIA
BEFORE THE SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES
JUNE 12, 2001

Madam Chairman and members of the Subcommittee:

Thank you for your invitation to appear today to testify in this hearing on the collection and disposition of federal oil and gas royalties taken in kind.

Introduction

In May 1998 I appeared before this Subcommittee to support MMS's effort to adopt new valuation regulations for federal royalty oil. At that time, we discussed the use of royalty-in-kind (RIK) sales. These are important issues for California. We have a large amount of federal oil production in California, and California's share of royalties goes directly to support its educational system. California is concerned that the recent Wyoming RIK experience not be misinterpreted and used to justify unwise and costly RIK policies.

As we pointed out in 1998, California has decades of experience in conducting RIK sales. The points we made then are still valid today:

- Long Beach and California have been conducting royalty-in-kind sales since the early 1970's.
  - RIK sales achieve prices consistently higher than posted prices.
    - Major oil companies, with rare exceptions, will not bid on RIK sales. The reason is that if they bid prices higher than posted prices, they would undermine their posted prices. They use posted prices as the basis for their royalty (non-federal) obligations, and for many of their purchases of crude oil from producers and non-working interest owners.

      4. Although RIK sales prices are consistently above posted prices, they are consistently below fair market values. We noted that Alaska North Slope (ANS) crude prices in Long Beach are consistently above the RIK prices in sales by Long Beach and California, as shown by the attached bar chart.

      For these reasons, we supported MMS's efforts to base federal royalties on readily available and competitive market prices, such as the spot price of ANS on the West Coast and the reported spot market prices for West Texas sour crude and West Texas Intermediate crude.

      The observations we made before this subcommittee three years ago about Long Beach and California's RIK sales are still true today: major oil companies still do not bid and RIK sales prices continue to be higher than posted prices, but lower than market values.

One final preliminary observation must be made: MMS published the new pricing regulations on March 15, 2000 to go into effect on June 1, 2000. Thus, MMS does not yet have any reliable data concerning the amount of royalties collected under the new regulations. MMS has not been able to compare the prices received in RIK sales of Wyoming crude oil with the prices they receive under the new regulations. Nonetheless, that is no reason to ignore the impact of these regulations in evaluating a pilot RIK program. Much less is there any reason to abandon the new regulations in favor of an all out RIK program on the basis of a very small pilot study.

The MMS Wyoming study

This brings us to the Wyoming study itself. As shown by the attached report, its most striking feature is that it is consistent with Long Beach's and California's experiences in RIK sales. First, as to participants, only 15 companies ever bothered to submit comments on the proposed program and only one, Exxon, was a major oil company. Only seven companies were winning bidders. None of the winning bidders was a major oil company. Most winning bidders were marketers or brokers, not refiners, which suggests that these firms could resell the oil to refiners at even higher prices.

Second, as in the California experience, the accepted bids were higher than the prices posted by the major companies.

Third, as discussed below, the RIK sales prices were lower than market prices.

Fourth, these sales of 1.6 million barrels over an 18 month period represent less than 1% of the total crude oil production in the Rocky Mountain area.

Canadian Crude Oils are a proper Benchmark to Evaluate the RIK Prices.

Contrary to MMS claims, Canadian crude prices are the appropriate standards for evaluating the Wyoming RIK program. The Rocky Mountain area is a crude deficit area, *i.e.,* it produces less crude oil than it refines. Canadian crude oils are the marginal supply for refineries in the Rocky Mountain area. Canadian crude oils are refined in Colorado, Wyoming, Montana and Utah and constitute about one third of the crude oil refined in the Rocky Mountain states. Canadian crude oil is an appropriate pricing benchmark for the Rocky Mountain area.

The RIK Prices are below Market Value.

We compared spot prices for both sweet and sour Canadian crude oils that are shipped into the United States with the three Wyoming RIK crude types. The RIK prices for Wyoming sweet crude were compared with the spot price of Edmonton Par crude (a sweet crude) after adjustment for transportation into Wyoming. See Figure 1 of the study by our consultant, which shows that the spot prices of Edmonton Par crude were significantly higher than the RIK prices for the relevant time period. The difference was

$2 to $3 per barrel. Put another way, the RIK prices were $2 to $3 per barrel below market value.

The RIK prices for Wyoming General Sour crude were compared with the spot prices for Canadian Bow River Crude oil (a sour crude oil). (See Figure 2). In the early months of the pilot program, the Canadian Bow River spot price exceeded the RIK price for Wyoming General sour crude by as much as $4.50 a barrel, although in the last five months of the program, the prices fell much closer in line.

We also compared the RIK prices for Wyoming Asphaltic crude with the spot prices for Canadian Bow River crude (see Figure 3). The RIK price was considerably below the Canadian crude price during the first pilot sale and then was not as much below the Canadian crude price in the other two pilot sales. RIK prices for Asphaltic crude reached near parity with the spot prices of Canadian Bow River crude oil in the second half of the third sale.

The fact that Canadian crude oils were generally priced above the RIK pilot prices is evidence that the RIK sales prices usually did not equate to market value.

MMS was wrong to reject Canadian Crude Oils as Benchmarks.

MMS alluded to three reasons why Canadian crude oils should not be used as a benchmark for the RIK sales prices. First, not all Wyoming crude oils compete with Canadian crude oil at Billings (Montana). Second, Canadian crude production is less mature than Wyoming crude production. Third, Canadian crude is transported to both Midwest refineries and Rocky Mountain refineries. None of these is a valid reason to reject Canadian crude oils as benchmarks for RIK sales of Wyoming crude oils. None of these considerations is sufficient to reject Canadian crude as a benchmark with which to compare the Wyoming RIK prices. First, whether Canadian crude oils compete with Wyoming crude oils at Billings is irrelevant. They do compete with Wyoming crude oils generally in the Rocky Mountain area. Second the fact that Canadian crude oil production is less "mature" than Wyoming crude oil production is similarly irrelevant. Presumably, MMS means that crude oil is cheaper to produce in less mature areas than in mature areas. Although that fact may be important to the profits of crude oil producers in both areas, that is no reason why it should have anything to do with how much refiners should be willing to pay for crude oils. Therefore, the maturity of crude oil producing areas does not affect the market values of crude oils.

Finally, both Canadian crude oils and Rocky Mountain crude oils are refined in both the Rocky Mountain area and the Midwest. These crudes compete with one another in both areas.

Other alleged Benefits of RIK Sales

MMS admits that, because it is still developing its processes for managing RIK, it is unable to document cost savings at this time. Just as the costs of the RIK program are uncertain so are the costs of using the new MMS valuation regulations. In analyzing the possible benefits of the RIK program, MMS has compared the RIK prices with posted prices and not with the prices established by the new valuation regulations. The proper comparison is with the prices established by the new valuation regulations. So, too, in documenting any cost savings achieved by RIK sales, the cost of the RIK program should be compared to the cost of implementing the new valuation regulations. Those regulations, like the RIK program, are designed to reduce the costs of auditing.

In short, because the costs of auditing under the new MMS valuation regulations are uncertain at this time, no legitimate estimate of any cost savings using RIK sales can be made at this time.

Congress should not take money from the states.

The probable losses from the Wyoming pilot underscore that Interior needs to experiment and evaluate the pros and cons of an RIK program further before Congress begins legislating. The need for legislation is, indeed, doubtful. The right to take in kind exists under current law. The respective obligations of the lessee and lessor are set out in the lease and in long held interpretations of leases. Neither the government nor industry has demonstrated a need for an additional authority to operate an RIK program. Moreover, other than speculation, no evidence has been offered that the additional authority requested will result in enhancing, rather than decreasing, royalty revenues to the public beneficiaries. It is noteworthy that the former Chairman of this Committee exempted his own State of Alaska from the RIK legislation then under consideration.

Under current law, states receive a percentage of the United States' "royalty interest." A royalty interest is a cost free interest. It is unlike, for example, a working interest, under which the owner of that interest shares in the costs of exploring, developing and operating the lease. The cost of those obligations that a lessee is required to perform are not deductible from a royalty interest.

The oil industry, however, seeks to allow Interior to use royalty revenues to pay for performing certain services - services that are not deductible from the United States' interest when royalties are paid in value.

Clearly, industry is supporting this added authority as an adjunct to its claims that federal lessees are not required to pay for these types of costs. Their assertion of a need for Interior to have funds to pay "downstream" costs is but a euphemism for post-production and marketing costs. Their claims for deducting those costs from royalties, however, were rejected repeatedly during the lengthy rulemaking leading to the 1988 regulations, and during the more recent rulemaking on the new oil rules. Interestingly, industry prohibits deducting those same type of costs when it is the royalty owner.

The oil industry advocates allowing Interior to use royalty revenues to pay for such matters as the hiring of independent brokers or marketers to sell production taken in kind. Let's be honest: if the government feels that it is inadequate to the task of marketing - that privatization will be of assistance - it should continue to take royalty in kind. Taking royalty in value is the essence of "privatization". Moreover, such "privatization" can only reduce the "royalty interests" of states like Wyoming and California by forcing them to assume costs that currently do not reduce their royalty revenues.

Last year, Congress finally passed legislation to end the Net Receipts Sharing program, under which the costs of Interior's administration of the mineral leasing laws were deducted from the states' share of royalties. As the Chair will surely recall, the Net Receipts Sharing program resulted in substantial disputes between the states and Interior because the federal government could not justify and account for its costs. Indeed, Wyoming was at the forefront of the Net Receipts sharing battle. The authority that industry seeks for Interior is simply Net Receipts Sharing in a different form.

If Congress wants the government to be in the oil business, it should appropriate the money to do so through the annual appropriations process, where its performance can be evaluated and budgeted on a yearly basis. What it should not do, however, is transform the very nature of the public's royalty interest into a working interest through the guise of making the in-kind program "permanent." If Congress wants Interior to stand in the shoes of a lessee, without the express consent of the royalty beneficiaries, the federal government should assume those costs that lessees assume today, leaving the states' and the public's cost free royalty interest intact.

I will be happy to answer any questions the Committee may have.

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